Ethiopia FDI Policy Report 2022

Main Findings and Recommendations

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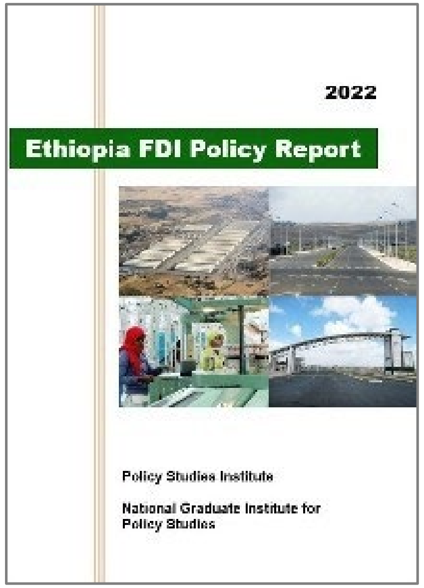
GRIPS Development Forum
January 27, 2022

Background



- GRIPS and JICA have conducted Industrial Policy Dialogue with Ethiopia since 2008. This report is one of its outputs.
- In 2020, Policy Studies Institute (PSI) and GRIPS Development Forum (GDF) co-authored the Ethiopia Productivity Report. This FDI study is the second joint product of PSI and GDF.
- Key authors are Dr. Mulu Gebreeyesus, Dr. Kiflu Gedefe Molla (PSI); Prof. Kenichi Ohno, Prof. Izumi Ohno, Ms. Sayoko Uesu (GDF); and Mr. Toru Homma (JICA) with secretarial and editorial support of Ms. Mieko Iizuka.
- There is a companion policy paper drafted by GDF which includes additional policy recommendations.

Ethiopia FDI Policy Report (2022) https://www.grips.ac.jp/forum/pdf22/EthiopiaFDIReport_final2.pdf

Companion paper (2021) https://www.grips.ac.jp/forum/pdf21/FDI_proposal_08.pdf

Ethiopia Productivity Report (2020) https://www.grips.ac.jp/forum/pdf20/ETProductivityreport_20200228.pdf

FDI Policy Report: Contents

xv + 243 pages

Companion Paper: Contents

"FDI Policy for Enhanced Value Creation in Ethiopia: Situation Analysis and Policy Proposals" (GDF, Oct. 2021), 28 pages

General Observation

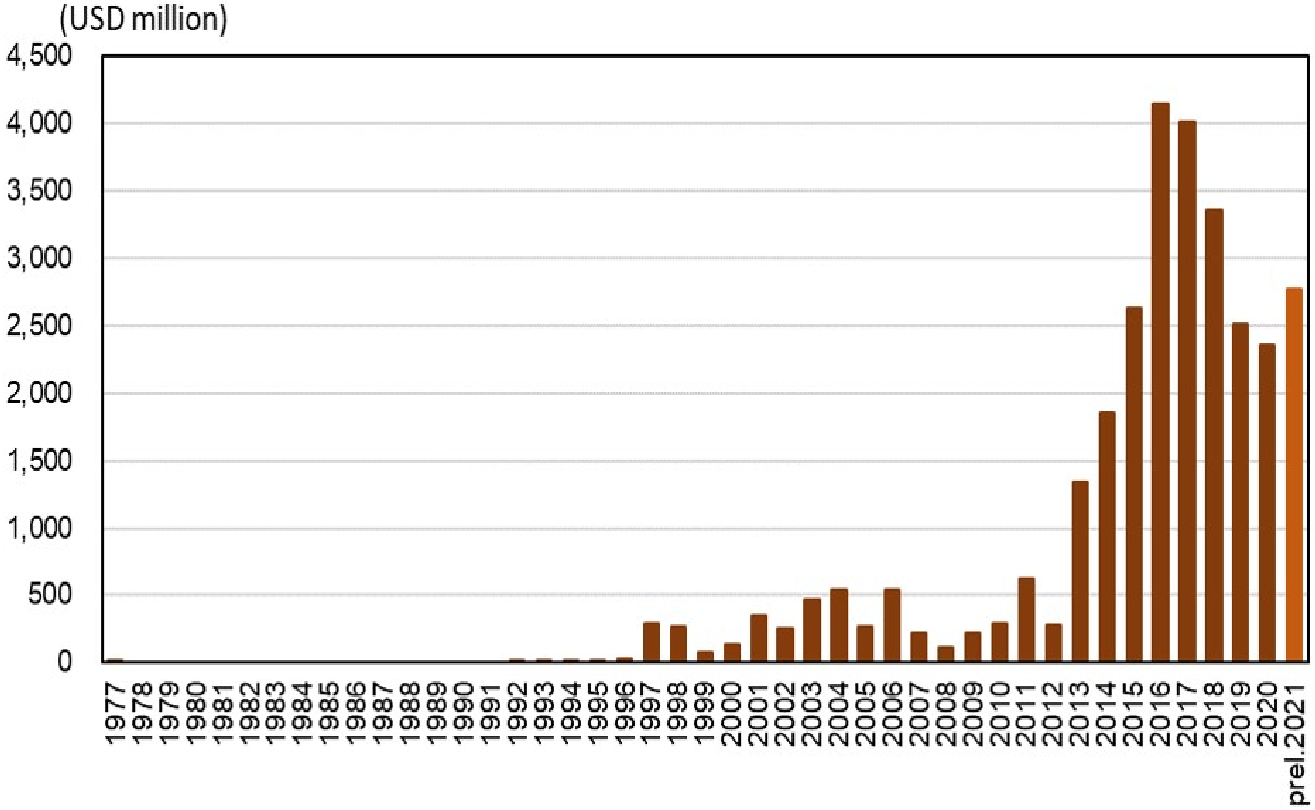
Despite high growth and large FDI inflow in the last two decades, the Ethiopian economy faces several problems.

- Macroeconomic difficulties—inflation, fiscal deficit, balance-of-payments imbalance, the chronic shortage of foreign exchange, and the shortages of basic commodities
- The lack of structural transformation and the weak performance of manufacturing
- Problems in the quality of growth, productivity and labor quality
- A weak private sector and low domestic value creation
- Recent growth slowdown

➔FDI policy revitalization is needed as one of the key measures to overcome these difficulties.

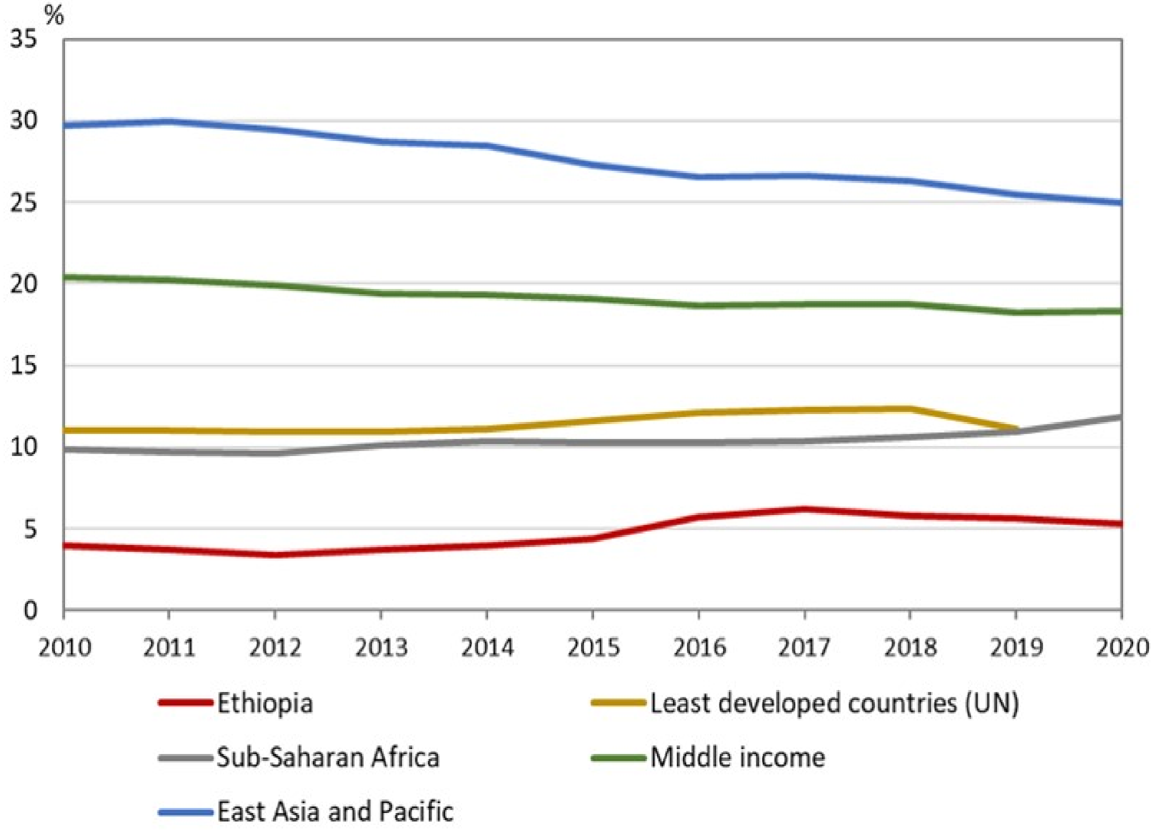
This report discusses FDI strategies to put Ethiopia on a robust growth path. We mainly focus on long-term and structural issues.

Net FDI Inflow into Ethiopia



Sources: For 1977-2019, World Bank, World Development Indicators (last updated on July 30, 2021, accessed on September 6, 2021. For 2020 and 2021, National Bank of Ethiopia data as reported in TradingEconomics.com which includes the license fee for foreign participation in the telecom sector amounting to $850 million; supplemented by recent news reports.

Manufacturing Share of GDP



Source: World Bank (2021c). East Asia and Pacific excludes high-income economies in the region.

Key Findings and Proposals

1. FDI policy: current status and future directions
2. Three-part strategy
3. Industrial park management
4. BOP and technology transfer
5. Comparing Ethiopia, Vietnam and Bangladesh
6. Two global requirements and challenges
7. Rebuilding and enhancing confidence

1. FDI Policy: Current Status and Future Directions (mainly ch.1&2)

- Ethiopia's FDI policy has been revised through a series of Proclamations and Regulations. It steadily became more open and favorable to FDI. Restrictions on FDI entry have been eased in steps. However, opening up is only the first step.
- The key argument of this report is that **FDI policy should be more selective and encouraging to FDI firms that bring new or additional value to the national economy.** This can be restated as a movement from quantity-based FDI to quality-based FDI.
- Here, value or quality refers to the generation of export earnings, transfer of technology and management knowledge, introduction of products or processes new to Ethiopia, upgrading of workers and engineers, procurement of domestic inputs and services, and assisting domestic firms to actively participate in global value chains.

Recommended Actions

1. The current policy does not clearly state **ultimate goals**. The role FDI should play in national development is also not plainly explained. **A new policy document** explicitly stating long-term goals, and strategies to attain them, is desirable (cf. Industrial Development Strategy of 2003).
2. The current policy is **more administrative than promotive**. It defines procedures but it is weaker in presenting **strategies to attract and incentivize high-quality FDI**. It is these latter provisions that are vital.
3. Ethiopia favors large factory operations that hire many workers. This is appropriate when job creation is a paramount national goal. However, **FDI that brings high technology and new products** should also be strongly welcomed. They are needed to move Ethiopia from simple manufacturing to more sophisticated one. Such investors are usually smaller and more varied in their requirements. For this:
   - **Minimum capital requirement** on FDI should be eased or removed.
   - **Smaller and more varied industrial space** should be offered in addition to large standard-size rental sheds.

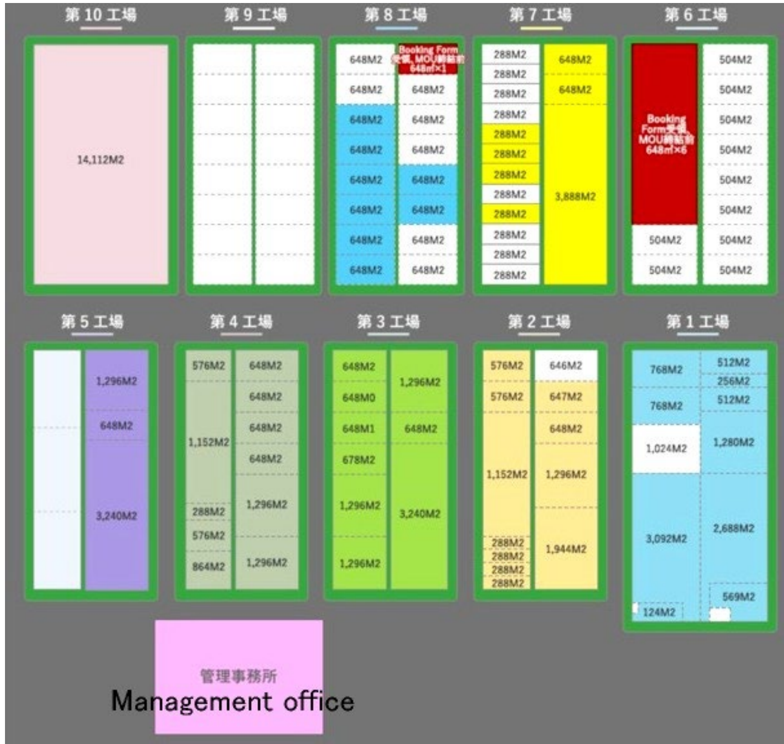
Small Rental Factories in Vietnam

Large sheds are partitioned into 250-1,000m² spaces

High-quality investor support and security are provided

500m² rental space is highly demanded

Greenery is a pleasant addition



Addendums and Caveats

- FDI is a game of **double maximization** where foreign firms maximize profit under the policy framework defined by the host government. Government must set policy parameters in such a way to induce the best response of foreign firms for national development.
- Value creation **should not be forced but encouraged** by incentives and other conditional favors. Government should not dictate foreign firms. The final decision must be made voluntarily by each FDI firm.
- “Quantity” investors and “quality” investors should be **simultaneously pursued**. Ethiopia still needs to create many jobs. Transition from quantity to quality must be an overlapping process.
- For fairness and transparency, FDI’s **performance criteria** must be simple, unambiguous and monitorable. The **capacity of executing agencies** must be strengthened with good mutual coordination (EIC, MOI, IPDC, revenue & customs, technical institutes, etc.)

2. Three-part Strategy (ch.2)

(i) Improving capacity of domestic labor and enterprises

Labor
- Mindset resetting
- Technical training
- TVET-industry linkage
- Incentives & career path
- Labor rights & health
- Migration support

Enterprises
- Management
- Kaizen
- Handholding
- Benchmarking
- Export support
- Quality-cost-delivery (QCD)
- Sector-specific technology

(iii) Linkage promotion
- Trade fairs & exhibitions
- Supplier database
- SME product display
- FDI-local matching events
- Individual matching service
- Incentives for local partner training, local procurement & technology transfer

(ii) Attracting FDI that transfers skills and technology
- Proper FDI targeting
- Strategic & high-level marketing
- Appropriate incentives
- Reliable infrastructure
- One stop service
- Industrial parks
- WTO, AGOA, EBA, FTAs
- Business climate (incl. WB Doing Business)

Common enabling conditions

Policy clarity	Legal framework	Support institutions	Quality bureaucracy

The strategy consists of:
- **Domestic capacity improvement**
- **Attraction of high-quality FDI**
- **Linking the two**

Domestic firms must work with FDI. Formation of FDI enclaves should be avoided.

Blue letter items are concrete policy actions recommended in the Ethiopian context.

Domestic Capacity Building

- Strengthening domestic labor and enterprises is the very core of any industrial policy.
- Recommended actions in the above diagram are all desirable, but all cannot be introduced at once due to capacity and budget limits.
- Prioritize. Select a few actions, concentrate policy attention and resources, and produce visual results rather than trying many measures superficially. This process facilitates policy learning.

Attracting Value-creating FDI

1. FDI policy should gradually shift from **quantity** (investment size, job creation, gross exports) to **quality** (technology, management, value creation, GVC). Quantitative targets need not be abandoned, but quality should also receive appropriate incentives.
2. FDI of all sizes, not just large labor-intensive ones, should be invited. High-tech firms are usually smaller.
3. Government should respond to the diverse needs of value-creating FDI firms. An effective mechanism to hear their voices must be in place.
4. Policy must be stable and predictable. Any change should be announced well in advance to give sufficient lead-time for adaptation.

Linkage Formation

- FDI-domestic firm linkage includes (i) procurement of materials, components and services, and (ii) long-term business partnership through joint venture, production cooperation, etc.
- Common tools include

Trade fairs and exhibitions	FDI-local firm matching service
Supplier database	Individual matching service
SME product display centers	Incentives for partner training, local procurement and technology transfer

- Government may directly offer linkage creating services, or indirectly subsidize firms that engage in FDI-local linkage and technology transfer. Encourage and guide them, but not force them into unwanted actions.

BUILD Office in Bangkok

Thailand BUILD

- Thailand has a reasonably good (though not perfect) linkage policy. The Board of Investment (BOI) and the Ministry of Industry (MOI) are the key official actors.
- **The BOI Unit for Industrial Linkage Development (BUILD)** specializes in FDI-local firm linkage with the following functions:
  - Matching service for sourcing local inputs and finding business partners
  - Organizing a large annual subcontracting exhibition (SUBCON Thailand)
  - Managing ASEAN Supporting Industry Database which is accessible globally
  - Subsidizing Thai firms that participate in overseas trade fairs
- Other linkage promoters in Thailand:

  MOI Bureau of Supporting Industry Development (BSID), One Start One Stop Investment Center (OSOS), Business Opportunity Center (BOC), Industrial Estate Authority, component industry association (A.S.I.A.), private NPO (TPA), two Japan Desks

3. Industrial Park Management (ch.2)

- Industrial parks are a real estate business with inevitable ups and downs. Ethiopian industrial parks must (i) generate profits, (ii) improve competitiveness, and (iii) prepare against unfavorable times.
- Six suggestions are offered.
    1. Diversify revenue sources (not just land and shed rents).
    2. Provide facilities and services strategically; do cost-benefit analysis.
    3. Customer-oriented investor services and park operation.
    4. Protection against negative shocks; build slowly and cautiously.
    5. Don’t insist on sector selectivity; accept all.
    6. Offer diverse land and shed choices, including small ones.

4. BOP and Technology Transfer (mainly ch.3&4)

- The impact of FDI on the balance of payments (BOP) and technology transfer are not automatic. They require appropriate domestic conditions.
- Both theory and international data suggest that FDI has an ambiguous effect on BOP. The impact depends on the country and the specific sector.
- Possible negative effects come from (i) initial importation of equipment and construction materials, (ii) a lead time before operation reaches full capacity, (iii) heavy dependency on imported inputs, and (iv) projects that generate little domestic value-added.
- Ethiopia lacks a clear strategy and effective incentives for technology transfer and FDI-local linkage unlike China, Singapore or Malaysia. Other problems include (i) foreign firms mainly interested in domestic market, resources or cheap labor, (ii) limited local capacity, (iii) macroeconomic instability, and (iv) political instability.

5. Comparing Ethiopia, Vietnam and Bangladesh (ch.5&6)

Firm surveys were simultaneously conducted in three countries for qualitative findings and identification of challenges during November 2020-January 2021.

	Researcher(s)	Number of firms	Location
Ethiopia	Dr. Mulu Gebreeyesus and Dr. Kiflu Gedefe Molla, PSI	10 garment firms (4 local, 6 FDI), 20 firms in automotive, leather and food sector	Addis Ababa and vicinity only.
Vietnam	Dr. Le Ha Thanh, Vietnam Development Forum (VDF)	31 garment firms (21 local, 5 FDI, 5 equitized SOEs)	Hanoi and vicinity only.
Bangladesh	Dr. Monzur Hossain, Bangladesh Institute of Development Studies (BIDS)	30 garment firms (25 local private, 1 JV, 4 FDI)	Dhaka and vicinity only.

Ethiopia as a Newcomer

- Vietnam and Bangladesh are well-established large apparel exporters while Ethiopia is a latecomer. It is natural that Ethiopia lags behind the two in product types, export volume, management and technology.
- However, we must ask whether Ethiopia's less spectacular performance is due only to time or if there is any structural problem that needs to be solved.

	Per capita GDP (WB 2019)	Textile and garment sector		
		Export (UNCTAD 2019)	No. of firms	Employment
Ethiopia	$856	$0.143 billion 5.4% of total export	176	0.1-0.3 million?
Vietnam	$2,715	$40.3 billion 9.6% of total export	7,627	1.56 million
Bangladesh	$1,856	$34.6 billion Over 80% of total export	3,500	4 million

Note: comparison requires caution as definitions and scopes differ across countries, especially for the number of firms and workers. Export data also have discrepancies depending on the source.

Country Profiles



Vietnam

- Apparel export boomed after opening up in the 1990s. FDI from Japan, Korea, Taiwan, etc. Cheap and hardworking labor. Many regional and bilateral trade agreements ensure overseas markets.
- Many firm types including private, FDI, former state-owned and military. Private sector dominates in firm number (98.6%). Garment association (VITAS) supports the industry.

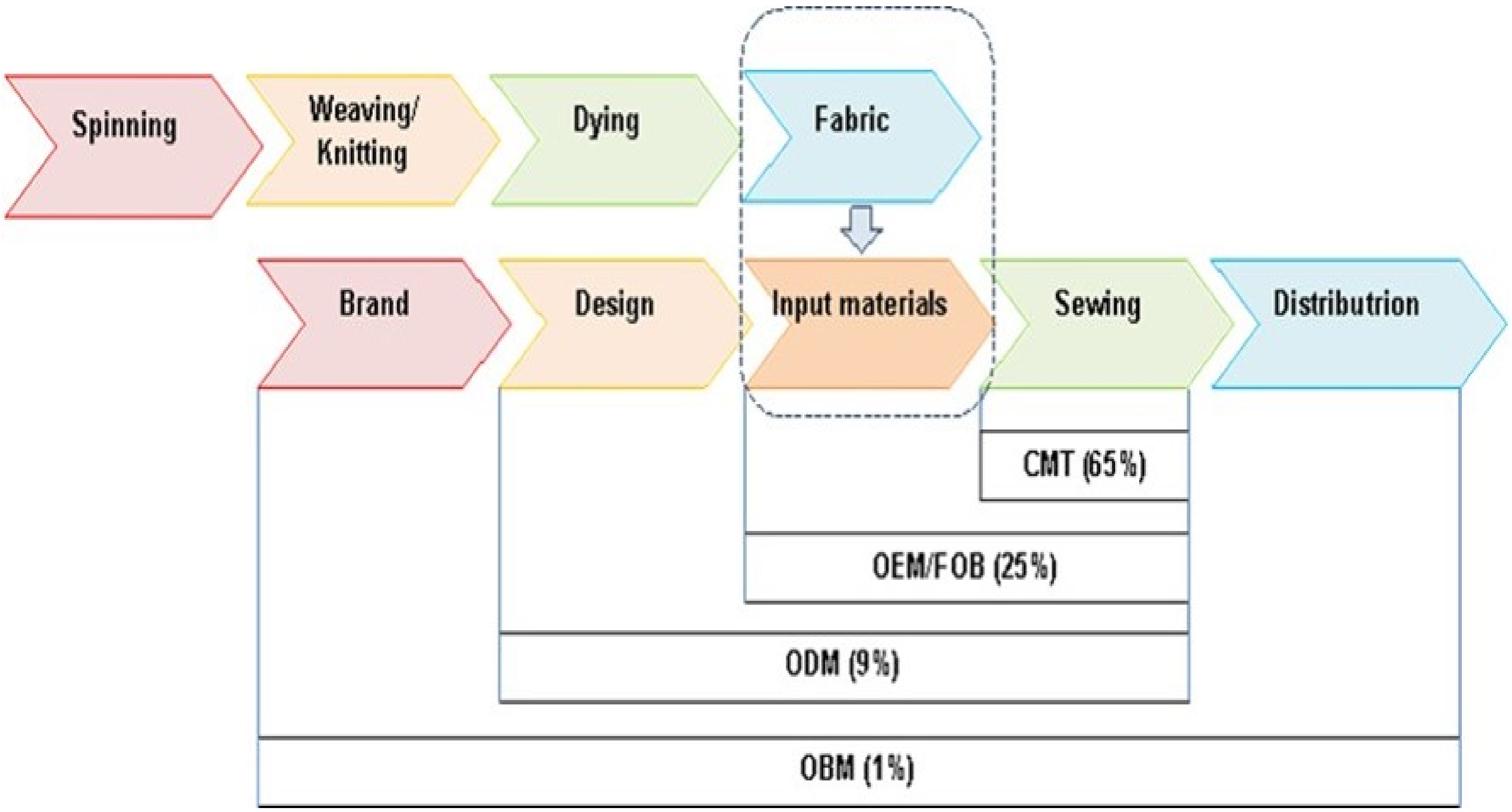
Bangladesh

- In 1974, Daewoo (Korea) assisted the creation of the Ready-made garment (RMG) industry. Robust growth despite many challenges (end of MFA 2005, Rana Plaza accident 2013). No FTAs with major markets.
- Domestic private firms dominate (98%), FDI firms are few. Two powerful garment associations (BGMEA & BKMEA) support the industry effectively. Government provides subsidies for domestic fiber use, short-term loans for export, 10-15% F/C retention, low currency value, bonded warehouses, etc.

Ethiopia

- The arrival of Turkish apparel makers from around 2008 (Turkey declined thereafter). China, India, Bangladesh, Sri Lanka, etc. also came. Active construction of state-run industrial parks. AGOA and EBA (however, AGOA was suspended in January 2022).
- Less than 100 firms have export capability dominated by FDI. ETIDI provides training and technical support. EKI supports with kaizen. ETIGAMA has about 100 members but its activities are relatively limited.

Domestic Value Creation



Source: General Statistics Office of Vietnam, Percentages show Vietnam's situation in 2019.

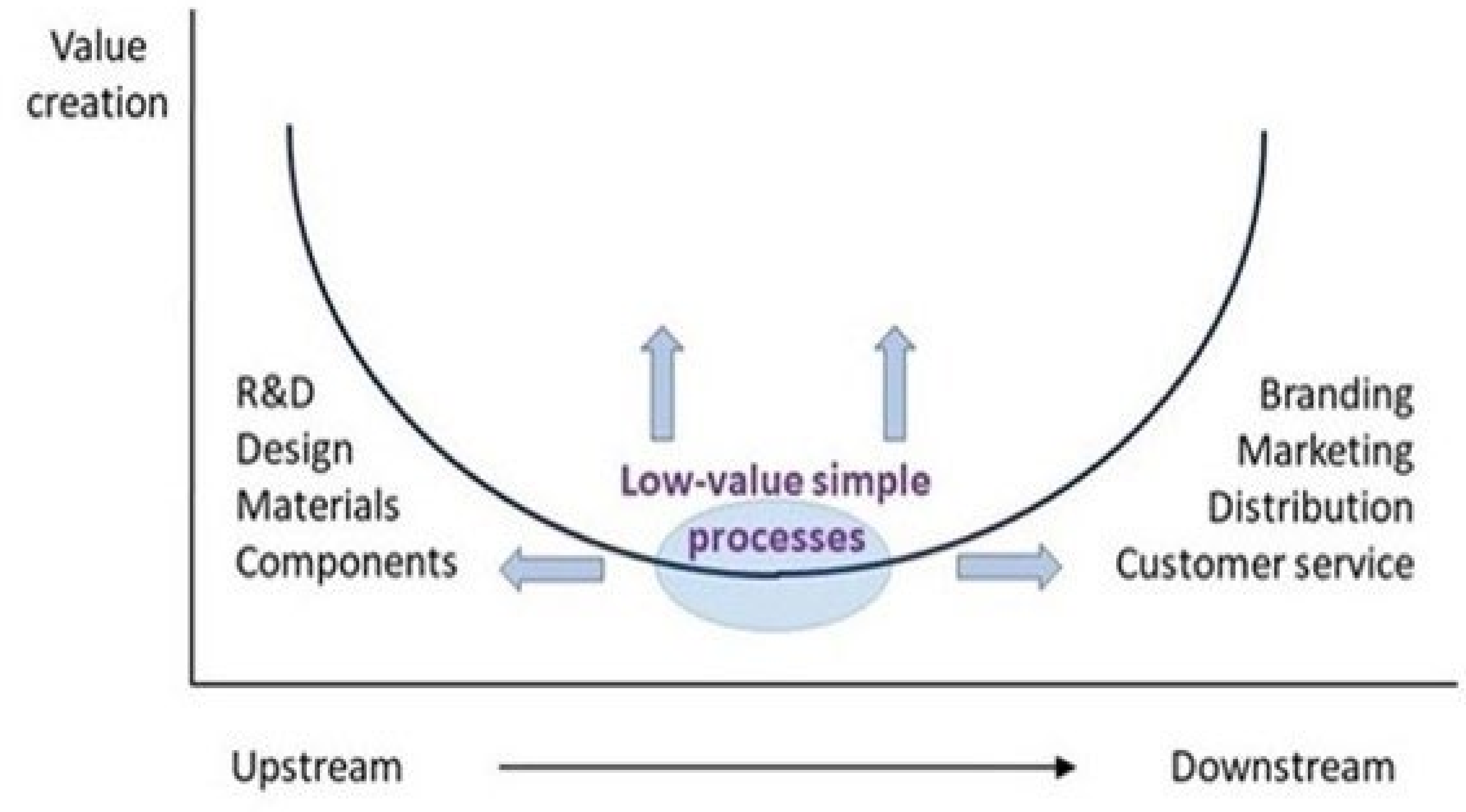
CMT (cut-make-trim), CM (cut-make) or CMP (cut-make-pack)
Receiving all materials from buyer; processing fee only

OEM/FOB (original equipment manufacturing /free on board)
Manufacturer procures materials at own cost and risk; receiving total product value

ODM (original design manufacturing)
Manufacturer proposes design, materials and specs to buyer

OBM (original brand manufacturing)
Manufacturer establishes own brand, and produces and sells for itself

Value Chain and Smile Curve



Latecomers usually start from the bottom of the curve where value is lowest, and try to expand vertically (productivity improvement) and horizontally (upstream and downstream expansion).

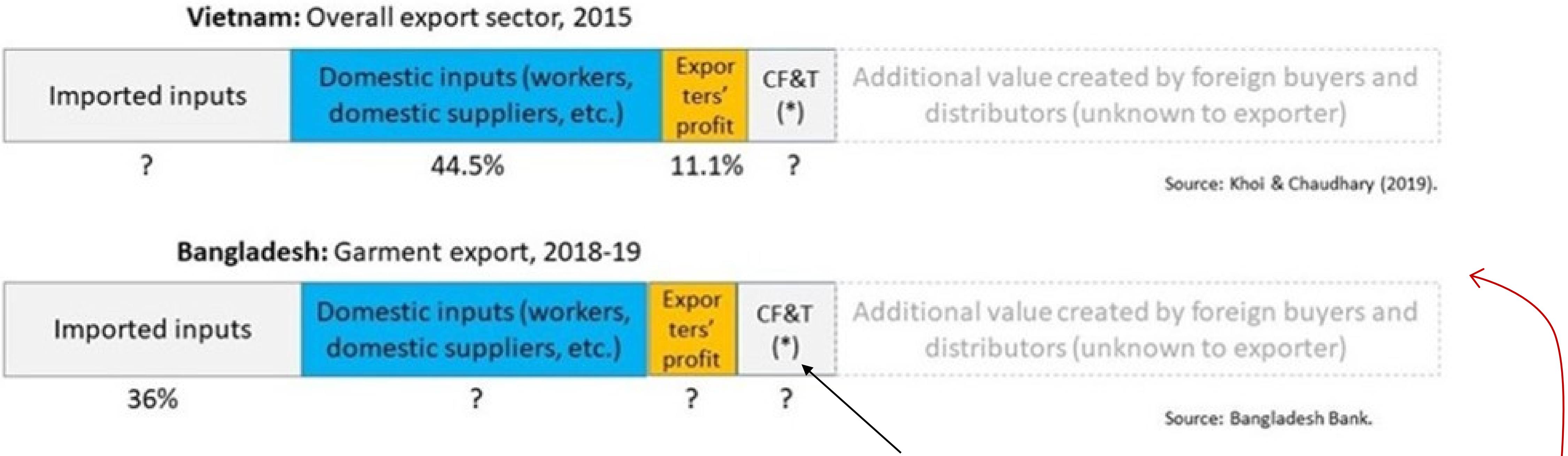
The two directions may be further subdivided into the upgrading of process, product, supply chain, end market, functions, etc.

From CMT to FOB

- In **Bangladesh**, FOB already occupies 70% of garment production while the remaining 30% is CMT. Fabrics and other materials are imported mostly from Hong Kong/China. Some accessories and knit fabric are locally produced. Some large firms even engage in ODM but the number is small.
- In **Vietnam**, CMT is still dominant (65%). FOB is reported to be 25%, ODM 9% and OBM 1%. The movement from CMT to FOB has been a policy goal since the 1990s but progress is slow. Domestic fabric and fiber production exists, but only for domestic use due to quality problems (separation of upstream and downstream).
- In **Ethiopia**, it is reported that, among FDI firms, 2/3 are FOB and 1/3 are CMT. But this reflects the strategies of individual foreign firms rather than Ethiopia’s domestic capability. Virtually all inputs are imported.

Participation in Global Value Chain

Vietnam and Bangladesh (Incomplete Data)



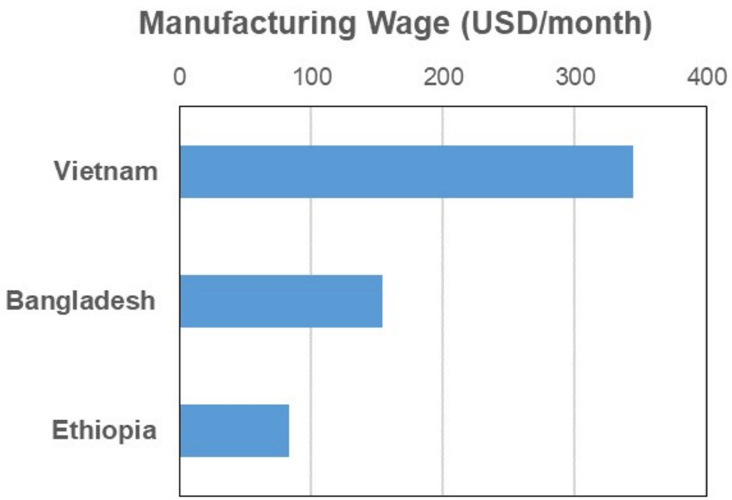
(*) Charges, fees & taxes paid to government and domestic & foreign agents for import, export & production

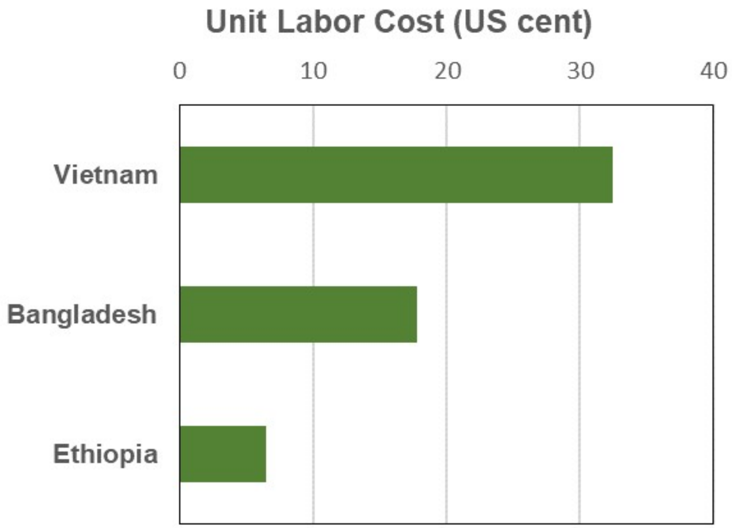
In both countries, domestic value creation is about 60% of apparel export value FOB. (No data for Ethiopia)

Note: the diagram shows the composition of export value FOB. The value in foreign retail markets, including the costs and profits of buyers and distributors, must be far greater than this. According to WTO, global apparel export (SITC84) was $495 billion while global apparel retail value was $1,438 billion in 2019. This means an additional $946 billion was created between export shipment and final purchase, a value almost twice as the export value.

Labor Cost and Productivity

- Monthly manufacturing wage (including bonuses, overtime, social security) was $344 in Vietnam, $154 in Bangladesh (2020); and $83 in Ethiopia (2016).
- Labor productivity: $12,700 in Vietnam, $10,400 in Bangladesh (2018); and $1,271 in Ethiopia (2016).
- Unit labor cost (labor cost for producing $1): 32.5 cents in Vietnam, 17.8 cents in Bangladesh (2018); and 6.5 cents in Ethiopia (2016).
- Ethiopia's labor cost appears very low. However, there are disadvantages that offset low labor cost:
    1. Products are relatively simple.
    2. Workers must be taught basics (rules, timeliness, discipline, etc.) before teaching technical skills.
    3. Investment climate is poor (F/C, power, logistics, customs, etc.)



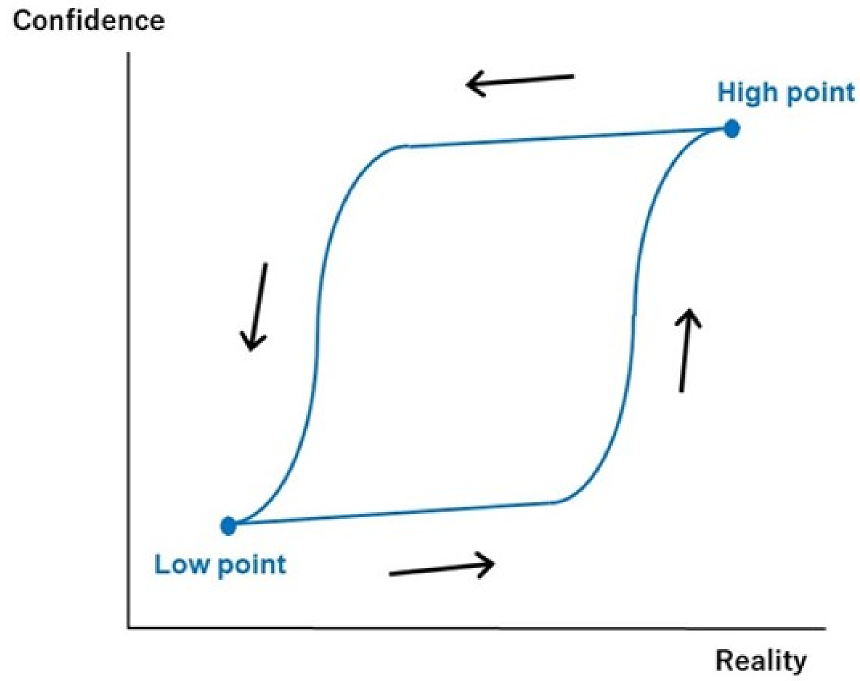


6. Two Global Requirements and Challenges (ch.7&8)

- Global buyers impose **product quality**. They also require **socially decent conduct** in manufacturing. Ethiopia must fulfill both. One problem is the proliferation of many overlapping standards and certifications (especially for ethical conducts).
- Assistance is sometimes available from foreign buyers, donors and international organizations. Domestically, government and industrial associations, if they are capable, should provide necessary support.
- Many developing countries incorporate the **idea of Industry 4.0** in their development plans, but substance is often lacking.
- Capacity building is needed to cope with the **negative aspects of AI and automation**, especially the fear of job loss.
- The COVID pandemic may accelerate the use of Industry 4.0 and open up new business opportunities. FDI and international cooperation must reflect these New Normal facts.

7. Rebuilding and Enhancing Confidence

- Ethiopia needs to augment investor confidence to fully realize its economic potential. FDI is affected by both **concrete facts** and **investor psychology**. Ethiopia must work on both.
- **Lost confidence is always recoverable** even after a severe crisis or conflict (cf. Cambodia, Rwanda, Vietnam, Sri Lanka, Ethiopia after Derg). But **restoration may take a long time** (many decades). Policy must accelerate and shorten it.
- Investor psychology is not linear but **hysteretic**. Perception first moves slowly, then begins to change rapidly. Policy effort may not produce immediate results but it must be continued until the critical point is reached.



Working on Investor Psychology

1. Investors evaluate **credible future policies** highly even if the status quo is far from satisfactory. Plan a bright future—large demand, ample skilled labor, rise of targeted sectors, etc.—and back it up with concrete actions.
2. Ethiopia should **stage a big policy regime change** with effective presentation. Policy components should not be offered piecemeal but in a coherent package with high visibility.
3. At the same time, **produce small but visible early results**. Initial results increase policy credibility and justify an investment decision.
4. Know the **differences among investors and nationalities**. Decision-making speed, time scope, technology transfer, etc. differ among Chinese, Indians, Koreans, Europeans, Japanese, etc. and even across individual firms.

Summary of Core Recommendations

1. A comprehensive FDI policy should be drafted

A new ground-breaking document should be created for renovating Ethiopia's FDI policy containing policy philosophy, long-term objectives, issues and areas to be improved, envisaged stages and concrete action plans. [Section 1-5; also 1-2 and 4-6]

2. A shift from administrative to proactive FDI policy

The main weight of FDI policy should shift from administrative provisions to more substantive promotional issues such as policy goals, targeted sectors, incentives associated with performance criteria, official support and public-private cooperation [Sections 2-6, 3-3 and 4-6; also 1-5, 3-4, 4-2]

3. Invite high-tech FDI along with large labor-intensive FDI

Ethiopia needs both types. High-tech FDI firms are smaller and more varied in needs than light manufacturing, and policy should hear and cater to their diverse requirements. The minimum capital requirement for FDI should be eased. [Sections 2-6 and 2-8; also 4-6]

4. Three-part strategy for capacity building, FDI and linkage

The strategy consists of (i) strengthening domestic firms and labor, (ii) proper FDI selection and attraction, and (iii) the creation of FDI-local firm linkage. Each demands serious learning and extensive preparation. Domestic capacity must be raised first to a certain level before FDI-local linkage can occur. [Section 2-7]

5. Industrial park management reform

Industrial park management should be upgraded in the following six aspects: (i) revenue diversification; (ii) strategic provision of facilities and services based on cost-benefit analysis; (iii) customer-oriented investor services and park operation; (iv) protection against expectable negative shocks; (v) invitation of FDI from all sectors; and (vi) diverse land and shed choices including small ones. [Section 2-8; also 1-3, 1-5 and 3-3]

6. Policy capacity building

To effectively execute the policy agenda above, Ethiopia needs clear performance criteria and the enhanced capacity of industrial officials to conduct and monitor each policy. In addition, the investment climate must be greatly improved. [Section 1-2]